11.01 Lease Accounting Basics

Overview

Definition of a Lease

ASC 842 defines a **lease** as "a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration." This is an extremely important definition since anything considered a lease generally must be recognized by the lessee as a lease asset and liability on the balance sheet. There is, however, an exception for short-term leases (ie, 12 months or less).

Classification of a Lease

Depending on the nature of the lease, a lease generally may be classified as either an **operating lease** (ie, a true rental) or a **finance / sales-type lease,** which transfers substantially all the rights and risks of ownership (ie, more like a purchase/sale). In this section, we will begin by taking a look at the big picture, exploring some important general definitions, and covering the lease accounting basics.

Lessor	Lessee
Operating	**Operating**

Nonoperating
• Sales-type
  o with selling profit
  o without selling profit
• Direct financing – rare
	Finance

Lease Term

The lease term is the period of time during which the lease is expected to be in force. It begins at the commencement date and is the sum of the following:

- **Initial lease term** – This is the original *noncancelable* term of the lease that does not include any renewal periods.
- **Periods for which a renewal option is likely to be exercised by the lessee**
- **Periods for which an option to terminate is unlikely to be exercised** – This might be the case when a lease contains a provision that requires the lessee to pay a significant penalty to the lessor for not renewing the lease.
- **Periods for which a renewal option** (or option not to terminate) **is controlled by the lessor**

Initial Measurement of Lease Payments

Lease payments represent the amount that the lessee will likely pay for the use of the underlying asset (*not* including amounts allocated to nonlease components, see below) under the terms of the lease during the lease term, as defined above. Such payments may include:

- **Fixed Payments –** This is the amount the lessee is required to pay the lessor over the lease term, minus any lease incentives paid/payable to the lessee. Lease incentives may include:
  - Payments made to or on behalf of the lessee.
  - Losses incurred by the lessor to assume the lessee's preexisting lease with another party.
- **In Substance Fixed Payments –** These are payments the lessee is required to pay the lessor that appear to be variable, but they really aren't. For example, a clause is written in the lease to create variability of payments, but it has no economic substance.
- **Certain Variable Lease Payments** – These are rent increases based on a change in an index, interest rate, or comparable external factor (eg, CPI, Federal funds rate, etc.). Note: Other types of variable lease payments are *not* included in "lease payments."
- **Exercise Price of Purchase Option Reasonably Certain to Be Exercised** – Determining whether any option (ie, renewal, purchase, termination, etc.) is reasonably certain to be exercised is based on all relevant economic factors, such as:
  - Contractual terms/conditions compared with the market.
  - Leasehold improvements that are expected to have significant economic value to the lessee.
  - Costs relating to terminating the lease and obtaining a new lease.
  - The importance of the underlying asset to the lessee's operations.

For purposes of calculating present value (PV) of lease payments, a purchase option reasonably certain to be exercised will be treated as a lump sum paid at the end of the noncancelable lease term.

- **Penalties –** If the lease term reflects the lessee exercising an option to terminate the lease, then any penalties for such termination should be included in lease payments.
- **Amounts Likely to Be Owed under Residual Value Guarantees (for Lessee Only) –** In some cases, the lessee guarantees that the property will be worth at least a certain amount when it is returned to the lessor at the termination of the lease and, thus, must make up for certain deficiencies; this is referred to as a "residual value guarantee."
  - A lease provision that requires the lessee to make up for damage, extraordinary wear and tear, or excessive usage would NOT be considered a lessee guarantee of the residual value and would be treated similar to variable lease payments.
  - Amounts paid by the lessee to obtain a third-party guarantee of residual value would NOT be included in lease payments.
  - Guarantees of the lessor's debt are also NOT included.

Lease & Nonlease Components

Some contracts that contain leases will have various components, some of which are lease components and some of which are nonlease components. When that is the case, lease components and nonlease components are accounted for separately, and lease payments are

allocated to each of the separate components proportionately based on the **standalone price** of each lease and nonlease component.

- For example, **nonlease components** such as *maintenance service obligations* (ie, the lessor is required to maintain the property) are separated from the lease components of a contract and are generally recognized as incurred, depending on the entity's accounting policy for maintenance.
- Generally, only lease components are accounted for under ASC 842. There are, however, **practical expedients** for both lessees and lessors under ASC 842 to account for lease and nonlease components together, if elected. For *lessors* to take advantage of the option to not separate the components in a contract, both of the following tests must be met:
    - The timing and pattern of revenue for both components are the same.
    - The combined single lease component is classified as an operating lease.
- Some items specified in a lease, however, are *not considered components* and, thus, no portion of the lease payments are allocated to them. An item in a contract is a **component** if it conveys some benefit (ie, a *good/service)* to the lessee. Neither the administrative cost of setting up the lease nor the direct payment/reimbursement to the lessor of *costs associated with ownership* (aka, **lessor costs**), such as payment of **taxes/insurance** on the underlying asset, convey a good/service to the lessee that is separate from the right to use the property.
    - If taxes/insurance are billed to the lessee or the payments otherwise vary from year to year, the payments are treated like variable lease payments and, thus, are *not* part of the lease liability.
    - However, if taxes/insurance are included in the lease payment, the entire payment is still just treated as a lease payment—there is no allocation (even if the amounts are itemized in the contract). For example, if $500 of a $4,000 annual lease payment is itemized in the contract as payment to the lessor to cover taxes and insurance; the $500 is still included as part of total $4,000 annual lease payment; it's not allocated separately.
    - Lessors are generally required to include any such amounts (ie, lessor costs) collected from the lessee in lease revenue and then expense them accordingly.
        - Any lessor costs the **lessee pays directly to a third party** are **excluded** from the lessor's revenue/expenses.
        - Lessor costs paid by a lessor and **reimbursed by the lessee** are accounted for as variable payments (ie, **included** in lessor's revenue/expenses).
        - Also, due to the complexity of determining whether certain sales taxes and other similar taxes are considered lessor costs, there is an **election** for lessors to simply **exclude amounts collected for sales taxes** (and other similar taxes) from lease revenue/expenses. If elected, disclosure is required.

Disclosure Requirements

Disclosures for leases by both lessor and lessee are very comprehensive. (If in doubt, disclose.) Generally, the overarching requirement is to show disclosures that enable users of financial information to assess the amount, timing and uncertainty of cash flows from leases. Disclosure requirements are both qualitative and quantitative.

Qualitative disclosures for both **lessee and lessor** include a general description of the following: lease arrangement, variable lease payments, options, nonlease payments and residual values.

Quantitative disclosures for **lessees:**

- Interest and amortization costs for finance leases
- Lease costs disclosed separately for operating and short-term leases
- Any variable lease costs
- Weighted average lease term
- Discount rate used in calculation of PV
- Reconciliation of beginning and ending balances of right-of-use asset
- Contractual obligations and options that the lessee is expected to exercise for each of the next five years, and a total for the remaining years in the aggregate.
- Future lease payments by type of lease for each of the next five years and a total for all remaining years, undiscounted.
- Lease transactions with related parties

Quantitative disclosures for **lessors**:

- Explanation of assumptions and judgments
- Lease revenues received
- Lease sales (vs. regular sales)
- For each type of lease, future lease payments for each of the next five years and the total for all remaining years in the aggregate.
- A reconciliation of sales-type lease receivables with total balance sheet receivables
- Gross investment and net investment in leases
- Description of assets under operating leases, risks associated with residual values and important changes in unguaranteed residual values